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SUBJECT: WHAT IS DRIVING IRAQ'S DECLINING INFLATION RATE

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¶1. (SBU) SUMMARY: Inflation in Iraq is on a downward trend, reflecting improved security, supply and targeted monetary policy. A close examination of the country's inflationary trend revealed poor security compounded by increasing demand--especially for fuel--to be the major inflationary pressures. Tight monetary policy enacted by the Central Bank of Iraq helped curb inflation with the dinar appreciating approximately 17 percent against the dollar since September 2006. Declining inflation is helping the average Iraqi and increasing domestic confidence in the government's economic policies. At the same time, however, banking and other economic reforms need to be moved forward to capitalize on lower inflation and create sustainable private sector jobs in Iraq's oil-based economy. END SUMMARY.

Recent Decline in Inflation Trend

¶2. (SBU) Inflation in Iraq is trending downwards, with the consumer price index (CPI) reaching just 15.5 percent year-on-year (y-o-y) in November 2007, due largely to the increase in all the prices of commodities and services groups, especially foodstuffs, fuels, transportation, and communications. This is encouraging when compared to a spike in inflation from 22.3 percent in January 2006 y-o-y to 41.9 percent y-o-y in February 2006 following the Samarra mosque bombing, which was then followed by an all-time post war high of 76.6 percent y-o-y for CPI in August 2006. Inflationary growth hovered in the 50 percent range for almost all of 2006, and finally began easing in the spring of this year, with a substantial drop in February 2007 to 37.1 percent y-o-y.

¶3. (SBU) Core inflation's trend mimics CPI for the most part, albeit at a lower level. Iraq's core inflation is defined as the rate of change of CPI calculated by excluding three fuel derivatives items of kerosene, LPG, and gasoline. Core inflation was 30.7 percent y-o-y in February 2006, climbed to 38.1 percent y-o-y in July 2006 and reached just 14.4 percent y-o-y this November.

How Inflation is Measured in Iraq

¶4. (SBU) Inflation in Iraq is measured by the Ministry of Planning and Development Cooperation's Central Office for Statistics and Information Technology (COSIT). Although understaffed and under-resourced, COSIT is working to update its methodology and further refine its measurements. A senior USAID consultant to COSIT told Econoff during a meeting on November 22 that COSIT is making steady progress to increase the efficiency of its data collection, and the statistics produced on a monthly basis are accurate. For example, data collection experts sample three black market

fuel providers located in the vicinity of official gas stations to calculate the price for fuel.

15. (SBU) The current base year COSIT uses is 1993. The base does not include the Kurdish provinces, and measures only 446 items in 60 markets. However, CPI will soon be calculated using the a new market basket as established by the new Iraq Household Social and Economic Survey run from November 1, 2006 until October 31 2007. The survey includes all 18 Iraqi provinces and measures 1,616 items as purchased by 18,144 households. Some initial findings of changes in income expenditure between 1993 and 2006 include: food expenditure dropped from 63.2 percent of income to 28 percent; fuel expenditure increased from 2.1 percent of income to 31 percent (although the 2007 formula includes housing and utilities expenditures); and the amount spent on transportation went from 4.9 percent to 10 percent.

High Demand, Constrained Supply Drive Inflation

16. (SBU) A close examination of Iraq's inflationary trend since 2004 revealed poor security compounded by increasing demand as the major inflationary pressure. Inflation remained high between February 2006 and summer 2007, but as the military surge lowered levels of violence, the inflationary rate declined in tandem, and in particular in Baghdad. The USAID consultant raised a particularly striking example: modern Baghdad's infrastructure was originally planned to accommodate 500,000 vehicles, with an attendant number of gasoline stations and other supply infrastructure to support that number. After 2003 demand soared for personal automobiles, which now total more than 1.5 million.

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Demand has similarly risen for other new purchases that require fuel, such as air conditioners and power generators. While this surge in demand was growing, the flow of goods and services was under severe strain due to dangerous transportation networks, attacks against refineries, and a shortage of supplies in the market exacerbated by official prices previously below regional levels. These factors led strongly to the high supply-driven inflation.

17. (SBU) Another factor fostering inflationary pressure is supply inelasticity due not only to poor infrastructure, but also linkages between regional markets. A senior US military officer noticed in summer 2007 visits throughout Iraq that the price of dates varied by a factor of 5 over a 75-mile highway distance. The price of tomatoes varied by 25 percent over a similar distance and each of the two markets are supplied primarily by different countries--Syria and Iran--and not Basra province where they are in excess supply. (COMMENT: Econoff has encouraged in economic briefings to new PRT officers to seek to identify ways of capitalizing on regional trading relationships for their provinces, both inside and outside of Iraq, to ease these market inefficiencies that have very real consequences on the ground. END COMMENT)

18. (SBU) COMMENT: What is surprising is how quickly inflation responded when fuel supply shortages eased at the end of the summer and early into the fall. Although there is no one concrete factor, Econoff's meetings with numerous Iraqi government advisors and Iraqis themselves point to increased fuel availability at a reasonable, and in most cases official, price due to improvements in security. This is not just physical security, but the removal of sectarian actors who controlled fuel sales and enforcing delivery to major official gas stations. Combined with the official gasoline price rising to market levels to reduce smuggling incentives, this appears to be making a substantial difference in Baghdad. Even Minister for Oil Hussein Al-Shahristani told the press at the end to November that "decreasing violence has allowed his ministry to reopen gas stations across the

city. At those stations, where drivers last year sometimes waited for days to fill up, waits are now usually less than 15 minutes, decreasing demand for black-market gas". END COMMENT

But Tight Monetary Policy Helped Too

¶9. (SBU) Although supply-side issues have shaped Iraq's inflationary pattern in the past few years, tighter monetary policy enacted by the Central Bank of Iraq (CBI) has helped to dampen additional inflationary pressures. Alarmed by the steady climb of inflation in 2005 and the sharp increase in 2006, the CBI curbed liquidity by gradually appreciating the dinar approximately 17 percent against the dollar starting in September 2006 through December 2007. The International Monetary Fund (IMF) in a report yet to be released noted the appreciation of the exchange rate has succeeded in increasing the demand for dinars and contributed significantly to the drop in inflation. The IMF (in the same report) also is recommending the CBI continue dinar appreciation until core inflation comes down to near single-digit levels, which is important to continue to de-dollarize Iraq's oil-based economy.

¶10. (SBU) A senior TF-BSO consultant to the CBI met with econoff on November 28 and provided unique first-hand insight into how the CBI formulates and implements monetary policy through volume control. The auction price for the dinar at its foreign exchange auction often is set on an almost daily basis before the currency auctions by polling the nearby money traders. In August 2007 the CBI increased its required reserve ratio on government deposits from 25 to 75 percent in order to draw up excess liquidity from government deposits in commercial banks. Finally, the CBI also sells its own treasury bills directly.

Why this All Matters

¶11. (SBU) COMMENT: Current inflationary trends are helping provide breathing space opened by the improving security situation to translate into improvements in the quality of life for the average Iraqi. Previously inflation was underestimated and post-war Iraqis felt the full brunt of Saddam Hussein's distorted economic policies, remnants of which still exist, such as the free basic goods provided monthly in the Public Distribution System. However, the clear trend of a decreasing rate of inflation is a success story and can further improvements in supply elasticity. We

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will highlight via septel how a strong increase in demand for dinars is a vote of confidence by Iraqis in their domestic economy and their government's economic policies.

¶12. (SBU) On the cautionary side--maintaining tight monetary policy to curb inflation can restrict growth and limit lending capital for small and medium sized enterprises. In order to capitalize on the improving security situation, a more even playing field for private and commercial banks needs to be fostered against the state-owned and supported Rafidain, Rasheed, and Trade Bank of Iraq. Moving in this direction will help the private sector development that will assist tangible, sustainable job creation in Iraq's oil-based economy. END COMMENT
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